Council for INCLUSIVE CAPITALISM

Coalition for INCLUSIVE CAPITALISM

Jerome Powell
Chairman

Ann E. Misback
Secretary

Board of Governors
The Federal Reserve
Eccles Building
Washington, DC 20418

February 6, 2023

Re: OP–1793
Principles for Climate-Related Financial Risk Management for Large Financial Institutions
on managing the transition risks and social impact of climate change for a Just Transition

Dear Chairman Powell and Secretary Misback,

I write to provide comment in response to the Federal Reserve System ("Fed") Proposal OP-1793 ("the Proposal") recommending *Principles for Climate-Related Financial Risk Management for Large Financial Institutions* ("draft Principles"), which would lay the foundation for a high-level framework for safe and sound management of climate-related financial risks.

This application of the Fed's Supervision and Regulation authority to climate-related financial risks is important in a world increasingly threatened by not only the transition risks of climate change, but also economic inequality, which will compound systemic risk and threaten financial stability over time, particularly if financial institutions do not factor social impact into risk management practices at this crucial stage.

Across the country – and particularly within disadvantaged communities shouldering the transition toward a lower carbon economy – the largest of these financial institutions, with at least $100-billion in assets, hold unique influence over not only major firms and market participants, but also broader societal stakeholders, including low- to moderate-income (LMI) households, which are uniquely vulnerable to the social impacts of climate change, as the Proposal duly notes.[1]

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[1] Federal Reserve (2022) Proposal "OP–1793" in Federal Register v87n234; regarding "Other Nonfinancial Risk" and how else "the operating environment affect[s] the financial institution's financial condition and operational resilience as discussed in the strategic planning section" (p.75271), including "impacts on the financial institution's other … stakeholders, including low-to-moderate income and other disadvantaged households and communities" (p.75269).

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The Council for Inclusive Capitalism and Coalition for Inclusive Capitalism ("Inclusive Capitalism") are non-profit organizations which both reflect the perspectives and needs of a set of global corporate, investor, and public sector organizations committed to creating a more trusted, sustainable, equitable and inclusive economic system.[2]

Inclusive Capitalism and its stakeholders recognize that financial institutions will not have the impact they aspire to without making measurable progress on long-term value creation for all stakeholders in a way which is sustainable for the environment and respects people.

Inclusive Capitalism has worked to convene stakeholders across sectors, countries and interests in market-led efforts toward widely accepted standards disclosing sustainability-related practices and investments, which we believe are vital to capital markets delivering dynamic, equitable and sustainable growth.

Inclusive Capitalism supports the Proposal and is hopeful that the Board of Governors will strengthen the draft Principles in line with the comments and social focus of letter, to ultimately adopt a high-level framework for the management of risks posed by climate change, which clearly threaten financial loss, economic damage and social strain across society.[3] We also appreciate the coordinated approach taken by the Fed, Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC) as regulatory agencies which each supervise banking organizations and jointly recognize the risks of climate change.

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[2] The Council for Inclusive Capitalism and Coalition for Inclusive Capitalism are two U.S.-based 501(c)(3) nonprofit organizations supported through charitable donations. This letter represents the view of Council and Coalition staff who work with our corporate, investor and public sector stakeholders and members, and not its charitable supporters, Steering Committee, members or partners, and its reference of companies, individuals or groups does not denote their endorsement of the letter.

[3] regarding financial loss: NOAA National Centers for Environmental Information (2022) "Billion-Dollar Weather and Climate Disasters"; noting financial costs of extreme weather events within the United States have cost more than $2.475-trillion since 1980, and $270-billion in 2021 alone.

regarding economic damage: S&P Global (2022) "Assessing Countries' Vulnerability To Economic Losses From Physical Climate Risks"; noting the physical risks or climate change exposes over 4% of global GDP to losses.

regarding social strain: Intergovernmental Panel on Climate Change (IPCC) (2018) "Summary for Policymakers"; noting up to several hundred million are at risk of increased poverty due to climate-related risks, wherein social impact would be "concentrated amongst the economically and socially marginalized urban residents" (p.11).

The organizational expertise of Inclusive Capitalism is not in the science of climate change; however, we have led historical work across the financial ecosystem – including institutional investors, financial institutions and corporations – demonstrating that environmental and social impact are financially material drivers, which the system must address in risk management, value creation and future growth.

To empirically demonstrate the value of environmental, social and governance (ESG) factors, Inclusive Capitalism developed an evidence-based, market-led initiative with asset owners, investment managers and corporate CEOs, of US$32-trillion assets under management, to test the proposition that ESG factors create long-term shareholder value. Publicly released in 2018 as the *Embankment Project for Inclusive Capitalism* (EPIC), it was one of the first market-led efforts to identify specific and limited ESG metrics for generating long-term value. Participating CEOs announced their unanimous agreement that environmental and social impact are value-accreditive drivers of economic growth in a November 2018 *Wall Street Journal* advertisement, saying, "We have a role to ensure long-term value creation that can benefit all" — and the world's future strongly depends on it.[4,5]

In 2021, Inclusive Capitalism launched its Just Energy Transition workstream in response to requests by social, civil and faith representatives, climate science researchers, and finance and energy industry CEOs to assist them in determining what would comprise meaningful and achievable company actions toward a just transition.[6] The work drew from foundational literature

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[4] EPIC CEOs (2018) "Business Leaders Unite to Advance Long-Term Value Measures" in The Wall Street Journal (advertisement); noting more than 30 participating CEOs, representing $32-trillion of assets under management, announced their unanimous agreement on EPIC's findings in The Wall Street Journal, saying, "We have a role to ensure long-term value creation that can benefit all" – and the world's future strongly depends on it.

[5] Metrics from the EPIC Long-Term Value Framework have been integrated into the discussed WEF Stakeholder Capitalism Common Metrics (2020), as well as the U.S. Securities and Exchange Commission (SEC) Human Capital Recommendations (2020) of the SEC Investor Advisory Committee and Investor-as-Owner Subcommittee, which precipitated current SEC Proposed Rules for Climate-Related Disclosures (2022), whose preamble also referenced Coalition for Inclusive Capitalism comment (2021) connecting climate and human capital information through the EPIC Long-Term Value Framework.

Also in the United States, the U.S. House of Representatives Committee on Financial Services considered EPIC's findings with regard to the proposed U.S. "Workforce Investment Disclosure Act" (2020), which would require the SEC to include environmental, social and governance (ESG) disclosures in the qualitative reporting of publicly traded entities. Additionally, proxy advisory firm Glass Lewis also included EPIC among the ESG frameworks studied in its In-Depth Report on Human Capital Management (2021).

[6] Full list of collaborators is available here JET Framework Collaborators | Council for Inclusive Capitalism

and research on the topic of just transition including: the 2015 United Nations Framework Convention on Climate Change's Paris Agreement;[7] the International Labor Organization (ILO)'s Guidelines for a Just Transition Towards Environmentally Sustainable Economies and Societies for All;[8] and work from both the International Energy Agency (IEA) and the International Renewable Energy Agency (IRENA).[9] The resulting *Just Energy Transition Framework for Company Action* ("JET Framework") was unveiled during COP 26 in a roundtable with the Vatican and Church of England alongside industry, investor, science and social leaders. The JET Framework maps to both the Climate Action 100+ (CA100+)'s Net Zero Company Benchmark indicator,[10] as well as the World Benchmarking Alliance (WBA)'s Just Transition methodology[11] in order to enable financial institutions to recognize and reward company action taken to advance both social and environmental goals in their transition.

With that context, Inclusive Capitalism offers its comments addressing the below two questions, of the three questions posed within OP–1793, based on our work and our collaboration with Shift,[12] experts in the human dimensions of sustainability, including as they relate to climate change and climate change strategies:

- "In what ways, if any, could the draft principles be revised to better address challenges a financial institution may face in managing climate-related financial risks? [and…]
- "What other aspects of climate-related financial risk management, if any, should the Board consider?"[13]

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[7] United Nations Framework Convention on Climate Change (UNFCCC). (2021) "The Paris Agreement".

[8] International Labour Organization. (2015) "Guidelines for a Just Transition Towards Environmentally Sustainable Economies and Societies for All".

[9] A full list of references and related resources is available at JET Framework Resource Hub | Council for Inclusive Capitalism and in the bibliography of the Framework Report available at the same link.

[10] Climate Action 100+ (CA100+) (2021) Net Zero Company Benchmark | Climate Action 100+

[11] World Benchmarking Alliance (WBA) (2021) Just transition | World Benchmarking Alliance

[12] Shift is a 501(c)(3) nonprofit organization headquartered in New York City as the leading center of expertise on the UN Guiding Principles on Business and Human Rights, which works across continents and sectors to help redefine corporate practice.

This letter draws on Shift's additional expertise and resources, also are available shiftproject.org, for which Inclusive Capitalism is also grateful.

[13] Federal Reserve (2022) Proposal "OP–1793" in Federal Register v87n234, Questions 1–2, out of three questions posed (p.75268).

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Addressing social impact and risks of transition to a lower carbon economy (Question 1)

Financial impacts which result from the transition to a lower carbon economy pose an emerging risk to the safety and soundness of U.S. financial institutions, which can disrupt services to market participants, including the firms, communities and individuals which collectively constitute the economic backbone of the United States, ultimately threatening the nation's financial stability.[14] Moreover, the Proposal rightly underscores that these "adverse effects…could also include a potentially disproportionate impact on the financially vulnerable, including low- to moderate-income (LMI) and other disadvantaged households and communities".[15]

As research has demonstrated,[16] it is often LMI households and communities which are the most at risk to physical harm arising from climate change, due to their combination of high vulnerability and low ability to adapt to its impacts. This risk function holds particularly true for how the LMI households of industrial communities fare during transitions to a lower carbon economy, as decarbonizing businesses exit industries or decrease operations, disproportionately impacting the local communities which host those operations and low- to moderate-wage workers who power them. The means by which financial institutions anticipate and manage these risks can also exacerbate societal vulnerability, only compounding other financial market risks.

To consider the impact of climate-related risk on financial institutions' broad range of stakeholders, particularly LMI households and communities, the Fed's draft Principles should assess how the benefits and risks of transition to a lower carbon economy are managed across society, as well as the physical risks brought by climate change.

This would be an important step recognizing that large financial institutions have a supervised role in this shift by managing transition and physical risks among market participants and societal

[14] Ibid; noting "the economic effects of climate change and the transition to a lower carbon economy pose an emerging risk to the safety and soundness of financial institutions and the financial stability of the United States" (p.75267).

Financial Stability Oversight Council (FSOC) "FSOC Climate Report" (2021); noting transition risks' "impact on firms, market participants, individuals, and communities is likely to be more sudden and disruptive" (p.13).

[15] Federal Reserve (2022) Proposal "OP–1793" in Federal Register v87n234, "Proposed Principles" (p.75268).

[16] Environmental Protection Agency (EPA) (2021) "Climate Change and Social Vulnerability in the United States: A Focus on Six Impacts"; noting "most severe harms from climate change fall disproportionately upon underserved communities who are least able to prepare for, and recover from" physical and social impacts (p.9).

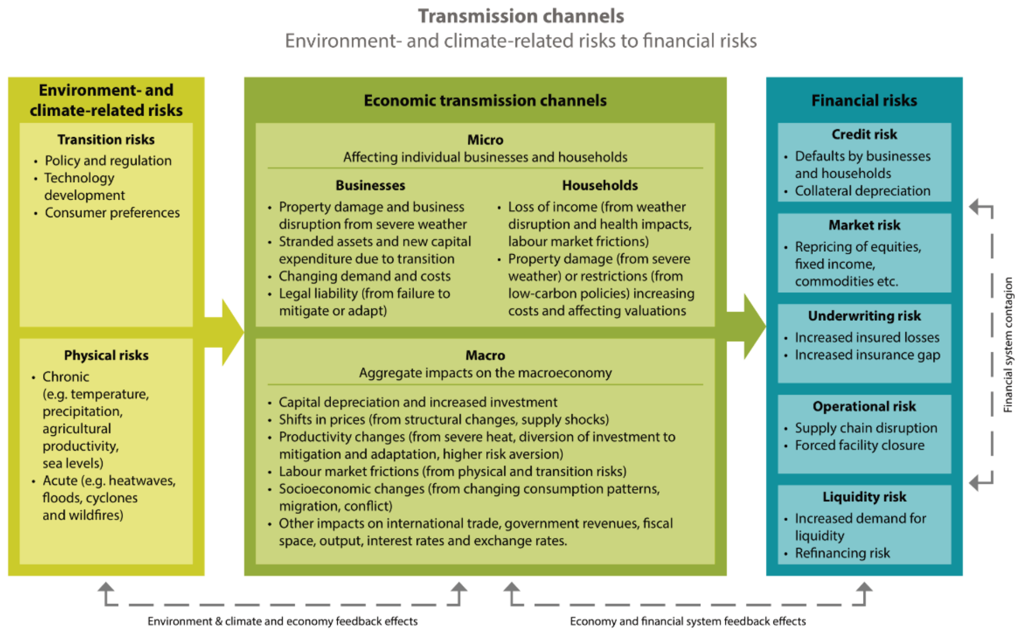
stakeholders in ways which are just for the people and local communities involved. After all, climate change has far-reaching and knock-on effects across regions and sectors, beyond financial institutions, their particular markets or direct customers.

In terms of financial stability, the Bank for International Settlements (BIS) – a consortium of central banks of which the Fed is a member – described climate change as "a new type of systemic risk that involves interacting, nonlinear, fundamentally unpredictable, environmental, social, economic and geopolitical dynamics." In its 2020 report on the role of central banks maintaining financial stability in the age of climate change, BIS goes on to state: "With the complex chain reactions between degraded ecological conditions and unpredictable social, economic and political responses, with the risk of triggering tipping points, climate change represents a colossal and potentially irreversible risk of staggering complexity."[17]

In its 2020 report on environmental risk analysis, the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) – a consortium of central banks of which the Fed is also a member – notes that both physical and transition risks stand to affect business operations and household wealth, with direct transmission channels into each of the financial risk areas which the Fed proposes for better supervision: Credit, Liquidity, Operational, and underwriting or Legal/Compliance Risk, as well as associated market risks, as diagramed on the following page.[18]

[17] Bank for International Settlements (2020), "Central banking and financial stability in the age of climate change" (p.14).

[18] Network of Central Banks and Supervisors for Greening the Financial System (2020) "Overview of Environmental Risk Analysis by Financial Institutions" illustration of transmission from environmental risks to financial risks (p.6); as adapted from NGFS (2020) "Climate Scenarios for Central Banks and Supervisors"; and as also re-produced in Federal Reserve (2023) "Finance Discussion Paper 1368" (p.11).



In light of the many important interconnections and pathways of transition, among physical, transition and other non-financial risk across market participants – and LMI households in particular – Inclusive Capitalism recommends that the high-level risk management framework being proposed by the Fed also address such social-related implications of climate risk, with a particular focus on LMI workers, communities and consumers.[19]

Without principles which better account for the social impact of climate-related financial risks, the Fed will miss critical opportunity to supervise financial institutions through a Just Transition, and the ensuing framework will undervalue investments in Just Transition Infrastructure, underestimate the vulnerability of LMI households, and ultimately contribute to long-term transition risks – instead of managing them.

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[19] For additional corporate actions which complement financial risk management and investor engagement for a Just Transition, see: Council for Inclusive Capitalism (2021) "Achieving a Just Energy Transition: A Framework for Company Action".

Other aspects of climate-related risk which the draft principles should consider (Question 2)

Reporting, Risk Management and Strategic Planning principles *should consider climate-related disclosures accounting for social impact and Just Transition, planning for the management of transition risks and long-term financial stability:*

As noted in the Board of Governors 2023 International Finance Discussion Paper on climate change,[20] public disclosures of banks and financial institutions should be expanded to include climate-related information on how banks are adapting their risk management, lending practices and business models to address climate change issues.

The disclosure of such practices is necessary to not only address societal shifts, as consumers and investors demand more sustainable financial services, but also fulfill the regulatory and supervisory responsibilities of central banks to better assess climate-related risks, as determined by the U.S. Financial Stability Oversight Council (FSOC) – of which the Fed is also a member, alongside the FDIC and OCC. It was toward that end, in the 2021 *Report on Climate-Related Financial Risk,* the FSOC ultimately recommended that the Fed and other FSOC members enhance climate-related disclosures within their supervisory authorities to ensure stability of the financial system.[21]

The FSOC stock-taking of globally systemic bank disclosures also noted that available information ranged across the primary categories of governance, strategy, risk and targets, as structured by the Task Force on Climate-Related Financial Disclosures. However, FSOC observed that even within this range, disclosures lacked consistency across reporting institutions, as well as assurances of their quality.[22] Moreover, in noting the "disproportionate impacts of climate-related risks on certain socially vulnerable groups," the FSOC underscored a key concern of Inclusive Capitalism that financial disclosures do not sufficiently account for the social impact of transition risks, leading financial institutions to under-report the threat to LMI communities and effectively under-manage associated financial risks.

[20] Beltran, Daniel O and Hannah Bensen, et al. (2023) "What are Large Global Banks Doing About Climate Change?" Board of Governors of the Federal Reserve System International Finance Discussion Paper No. 1368.

[21] Financial Stability Oversight Council (2021) "FSOC Report on Climate-Related Financial Risk".

[22] Financial Stability Oversight Council (2021) "FSOC Report on Climate-Related Financial Risk"; noting FSOC own reporting, as well as references to Financial Stability Board (FSB) and NGFS conclusions, respectively, calling for the "greater consistency, comparability, and reliability in disclosures across global banking organizations" (p.74) and NGFS for "assurance about the quality of climate-related data through verification and audit mechanism" (p.48)

Therefore, disclosure of information by financial institutions, as well as between lenders and firms, is also crucial to financial risk management, such that the Proposal's draft principle for "Data, Risk Measurement, and Reporting" (principle five of six) should be expanded to include the disclosure of strategic plans which manage the potential social impact of transition risks. Such a revision to principle five would also provide greater connectivity with draft principles three and four (on strategic planning and risk management, respectively), based on the concept of Just Transition.

***Scenario Analysis principle** should address any tensions or trade-offs between transition goals and social impact in order to assess vulnerability of all market participants, including LMI households, and manage transition risk over the long-term:*

The assessment of tensions between near- and long-term scenarios or between transition goals and social impact, and whether these necessitate trade-offs, is material to the forward-looking climate-related scenario analysis of financial institutions. As the draft principle lays out, scenario analysis should be comprehensive enough to include various objectives, including assessing vulnerability to transition risks and even "extreme but plausible scenarios." As discussed, social impact is a determinative factor of transition risk, and its management certainly constitutes a plausible (if not extreme) scenario to many industries, markets and communities, particularly within fossil fuel-related industry and operating environments transitioning to a lower carbon economy.

Therefore, the draft principle should also guide institutions to assess tensions or trade-offs between climate-related targets and social impact – including to workforce, communities and the local economy – accounting for plausible scenarios where social impact may produce higher financial risk.

***Strategic Planning principle** should recognize significant variance in time horizons when institutions factor social impact into transition risks, with particular attention to the long-term exposure of LMI households:*

The proposed framework intends to guide financial institutions in managing climate-related risk over a variety of time horizons, while setting overall business strategy, risk appetite and capital plans. However, given the various objectives of an institution's board, the range of market participants and long-term interests of financial institutions, the framework should also recognize that financial risk arising from transition risks or social impact might not appear significant over an institution's typical strategic planning cycles.

Therefore, the principle should clarify that risks associated with social impact may arise over time horizons which are even longer than the transition or physical risks which climate-related strategies aim to manage, and that institutions should assess the long-term exposure of LMI households among their market participants in strategic planning.

Policies, Procedures, and Limits principle *should recognize bank policies whose lending terms and time horizons account for social impact to an institution's operating environment:*

As draft principle two expects management to incorporate climate-related risk into a bank's policies – in line with the board's strategic direction – those policies should also recognize and incorporate the social impact of such policies on an institution's operating environment. This is particularly the case of financial institutions operating in industrial environments and whose terms may support businesses in their transition to a lower carbon future.

Therefore, the policies of such institutions should provide detailed guidance for the financial institution's expectations and terms regarding workforce transition plans, community impacts, affordable energy access and any trade-offs between near- and long-term social impacts.

Nonfinancial, credit and operational risk categories *should recognize social impacts of altering asset values and liabilities – particularly in the closure or sale of high-carbon PP&E assets – on LMI households in their operating environments.*

As the Proposal states, bank management should consider how climate-related risks impact its asset value, credit portfolio and other exposures, based on several risk categories, including: Nonfinancial Risk, stemming from negative financial impact on a bank's operating environment or its operational resilience; Credit Risk, stemming from transition factors or physical threats; and Operational Risk, stemming from the vulnerabilities of a bank's operating environment or threats to its business continuity.[23]

Important to assessing and mitigating these risk categories is also the social impact of a bank's risk management practices, particularly on the resilience of its operating environment, in the event of closure or sale of assets which ultimately become stranded by transition to a lower carbon economy. In the operating environments of fossil fuel-related industries, many communities economically depend on high-carbon property, plant, and equipment (PP&E) assets, and their closure or sale can result in negative social impact, reputational damage or increased risk, if not managed for a Just Transition. For example, if an asset transition strategy fails to maintain operating standards or honor social and environmental commitments, the converting, retiring or

[23] Federal Reserve (2022) Proposal "OP–1793" in Federal Register v87n234; noting these three categories within the Proposal's six total risk categories, as defined under "Management of Risk Areas" (pp.75270–1).

sale of PP&E assets can negatively impact the LMI communities which host the assets and low- to moderate-wage workers who have historically operated them.

Therefore, proposed risk categories should recognize the social impact of nonfinancial, credit and operational risk management, particularly in banks' monitoring of assets and their potential for negative impact on LMI households within the operating environment as employer industries transition to a lower carbon economy.

* * *

As Council for Inclusive Capitalism members stated in their support of convergence toward common standards for disclosing sustainability-related information: financial institutions must address social and environmental impact through standardized measures which recognize the long-term, societal value which their policies can create in the drive toward structural change.[24]

The crucial role of the Fed in supervising such financial institutions for a Just Transition is reiterated by the Grantham Research Institute at the London School of Economics in its Sustainable Central Banking policy paper, that "given the urgency of environmental deterioration, *central banks and supervisors must start now to work for a just transition*," and that "from a climate risk perspective, the absence of a just transition could result in vital decarbonisation efforts being delayed or even halted."[25]

That is why Inclusive Capitalism supports the Proposal and believes the Fed should continue to harness its Supervision and Regulation authority for the safe and sound management of climate-related risks toward the transition to a lower-carbon economy which is also just.

[24] Council for Inclusive Capitalism (2021) "Council Announces Support of Convergence Toward Common Metrics and Standards Around ESG and SDG-Aligned Investments".

[25] Grantham Research Institute on Climate Change and the Environment at the London School of Economics (2022) "Supporting the just transition: a roadmap for central banks and financial supervisors" Policy Briefing Paper 10 by Pierre Monnin and Nick Roberts (pp.14,7) [italicized emphasis added].

We are grateful for the Board of Governors' consideration of these comments, and for your commitment to the supervision of financial institutions to remain safe and sound for the benefit of all market participants.

Thank you.

Sincerely,

Lynn Forester de Rothschild
Founder and Chair, Coalition for Inclusive Capitalism
Founder and Co-Chair, Council for Inclusive Capitalism

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* The Council for Inclusive Capitalism and Coalition for Inclusive Capitalism are two U.S.-based 501(c)(3) nonprofit organizations supported through charitable donations. This letter represents the view of Coalition and Council staff who work with our corporate, investor and public sector stakeholders and members, and not its charitable supporters, Steering Committee, members or partners, and its reference of companies, individuals or groups does not denote their endorsement of the letter.

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